Pan-European REIT? – A long, long road.
By Fraser Hughes
Research Director, European Public Real Estate Association (EPRA)

Introduction
Europe is an extremely diverse region in political, economic and social terms. Every country is governed locally, under its own individual political process, determining its own legal and fiscal framework under European Union guidelines. Despite the introduction of the €uro on 1 January 1999, Europe still has nine individual currencies in circulation, within the twenty eligible European countries of the FTSE EPRA/NAREIT Global Real Estate Index. The countries are highlighted in table.1 below. Political and economic differences aside, many cultural differences exist between the countries. The European Union establishes a good degree of common ground between members; however the task of bringing all of these separately governed legal jurisdictions together under one common European REIT umbrella will prove both long and convoluted path. This task must be driven by trade associations such as EPRA.

Table. 1
FTSE EPRA/NAREIT Global Real Estate Index: The 20 Eligible European Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Currency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria * (€)</td>
<td></td>
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<tr>
<td>Belgium * (€)</td>
<td></td>
</tr>
<tr>
<td>Czech Republic ** (CZK)</td>
<td></td>
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<tr>
<td>Denmark * (DKK)</td>
<td></td>
</tr>
<tr>
<td>Finland * (€)</td>
<td></td>
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<tr>
<td>Germany * (€)</td>
<td></td>
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<tr>
<td>Greece * (€)</td>
<td></td>
</tr>
<tr>
<td>Hungary ** (HFL)</td>
<td></td>
</tr>
<tr>
<td>Ireland (€)</td>
<td></td>
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<tr>
<td>Italy * (€)</td>
<td></td>
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<tr>
<td>Italy * (€)</td>
<td></td>
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<tr>
<td>Luxembourg * (€)</td>
<td></td>
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<tr>
<td>Netherlands * (€)</td>
<td></td>
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<tr>
<td>Norway (NOK)</td>
<td></td>
</tr>
<tr>
<td>Poland ** (PZL)</td>
<td></td>
</tr>
<tr>
<td>Portugal * (€)</td>
<td></td>
</tr>
<tr>
<td>Spain * (€)</td>
<td></td>
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<tr>
<td>Sweden * (SEK)</td>
<td></td>
</tr>
<tr>
<td>Switzerland (CHF)</td>
<td></td>
</tr>
<tr>
<td>United Kingdom * (€)</td>
<td></td>
</tr>
</tbody>
</table>

* European Union member state pre-expansion on 1 May 2004
** European Union member state post-expansion on 1 May 2004
1. Countries with existing REIT legislation highlighted in light blue
2. Country with existing hybrid REIT structure highlighted in yellow
3. Countries who are discussing the introduction of REIT legislation highlighted in orange
() Individual country currencies in indicated in brackets

In table.1, of twenty countries listed, only four - Belgium, France, Greece and the Netherlands, have official REIT structures in operation. Italian investors utilise a hybrid structure. It is worth mentioning at this point that other ‘developing’ European countries not yet covered by the index do have existing REIT legislation, for example, Russia and Turkey. The obvious first step towards a common European REIT is to establish individual country REIT legalisation on a broader basis, throughout the European region. Graph.1 indicates that currently only 27% of the market capitalisation of Europe operates under REIT legislation. The two largest economies in the region – Germany and the United Kingdom, are still in deliberation concerning the introduction of REIT legislation. The UK, the most heavily weighted country in Europe, in market
capitalisation terms, comprises approximately 50% of the region. Total free float market capitalisation of the European market as at 30 June 2005 was $108 billion.

Graph.1

Pan-Europe Market Capitalisation Breakdown
30 June 2005

Total Mkt Cap = $108 billion

Source: FTSE EPRA/NAREIT Global Real Estate Index - 30 June

In Global terms, Europe comprises a disproportionately small slice of the listed real estate market. North America has well established REIT structures, Australia, Japan, Singapore, Hong Kong, Singapore, New Zealand and South Korea all have well established, or new formed REIT structures, however Europe lags far behind. Consequently Europe makes up less than 20% of total Global free float market capitalisation ($565 billion) – see graph.2. Incredible, considering Europe comprised 35% of the OECD Gross Domestic Product Total in 2004\(^1\). REIT legislation covers approximately 75% of the global real estate market.

Graph.2

Global Market Capitalisation Breakdown
30 June 2005

Total Mkt Cap = $565 billion

Source: FTSE EPRA/NAREIT Global Real Estate Index - 30 June 2005

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\(^1\) OECD Main Economic Indicators 2004 – Issued July 2005. OECD-Total includes the 30 major world economies.
EPRA Tax Transparency Committee (TTC)

EPRA strongly supports tax transparent initiatives throughout Europe. In general, evidence shows that tax transparency has stimulated growth and development in listed markets. Historically, tax transparent structures have provided a number of benefits. The beneficiaries include the governments, the companies, the institutional and private investors, and ultimately the tenants.

In order to meet these aims, EPRA introduced the TTC in 2002. Richard White of Ernst & Young in London is the chairman of the TTC. Under the leadership of the TTC, EPRA has, and will, support government initiatives wherever necessary in their preparations to introduce these tax transparent structures. EPRA is focused on the promotion, development and representation of the European listed real estate sector. Further, tax transparent structures deepen liquidity, meeting one of EPRA’s long-term goals.

What already exists? - EPRA Global REIT Survey

In order to set the scope of the REIT landscape, the TTC published its first EPRA Global REIT survey in 2003. The first survey covered Europe and the United States. Driven by strong demand for a broader publication, the TTC published the updated version of the EPRA Global REIT survey in September 2004. The updated survey covers all of the major existing REIT regimes around the world. Drawing from the detailed analysis contained within the survey, table 2 highlights the main features of existing REIT structures in Europe. The EPRA Global REIT survey compares these structures within a regional setting for Europe, Asia/Pacific and North America.

<table>
<thead>
<tr>
<th>Country</th>
<th>Established</th>
<th>Payout</th>
<th>Development</th>
<th>Gearing</th>
<th>Foreign Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Netherlands</td>
<td>1969</td>
<td>100% taxable profit</td>
<td>No</td>
<td>&lt; 60%</td>
<td>Max 25% by single non-national</td>
</tr>
<tr>
<td>Italy</td>
<td>1994</td>
<td>No obligation</td>
<td>Limited</td>
<td>&lt; 60%</td>
<td>No restrictions</td>
</tr>
<tr>
<td>Belgium</td>
<td>1995</td>
<td>80% of net profit</td>
<td>Limited</td>
<td>&lt; 50%</td>
<td>No restrictions</td>
</tr>
<tr>
<td>France</td>
<td>2003</td>
<td>85% of profit from leasing</td>
<td>Limited</td>
<td>Unlimited</td>
<td>No restrictions</td>
</tr>
</tbody>
</table>

Source: EPRA Global REIT Survey, 2004

And, what is coming?

The aim of this article is not to examine existing REIT legislation. The EPRA Global REIT survey comprehensively covers those existing REIT structures. Moreover, in Europe there are a number of significant developments taking place with the existing Dutch structure, and there is a very real possibility that Europe’s two largest economies – Germany and the United Kingdom will introduce REIT legislation in the next 24 months. These current discussions in Europe will have huge implications for the future of the listed real estate market.

Netherlands

The “Fiscale Beleggingsinstelling” (FBI) was introduced into the Dutch Corporate Income Tax Act of 1969. Currently discussions are taking place to relax restrictions for FBIs in terms of their development actives, capital taxes, foreign shareholders restrictions, withholding taxes and the abolition of the minimum required payout. The Institutionele Vastgoed Beleggers Nederland (IVBN), the Dutch Fund Association (DUFAS) and EPRA, are contributing to the debate with the Dutch Finance Ministry.

The purpose of the update, or the ‘luxury version’ as it has been named, is to make the FBI easier to market to foreign investors, effectively equivalent to the Luxembourg SICAV regime. The ‘luxury version’ would incorporate the following changes:

- No shareholder restrictions;

2 EPRA Global REIT survey is available from www.epra.com
3 Taken from: “Dutch REIT system” – Kempen & Co, 7 July 2005
• No minimum required distribution of dividends;
• No withholding taxes on distributed dividends;
• Reclaiming of paid withholding taxes would no longer be possible (no possibility to use treaty protection, which is possible under the current FBI structure.

Under the current trend towards REIT introductions in Europe, the current FBI structure has become outdated. The Netherlands is losing many investment funds to Luxembourg. Moreover, the French and Belgium REIT structures, and the proposed structures in the UK and Germany are a lot more flexible and less restrictive than the current FBI. Quite simply, changes are required for the FBI to become competitive again.

Ronald Wijs, tax partner at Loyens & Loeff Amsterdam, and Chief Editor of the EPRA Global REIT Survey, comments “I don’t think the “luxury version” is not going to take-off for Dutch REITS. As the new regime is likely to be fully exempt, with distributions not subject to withholding tax; including property in the regime would mean that rental income could flow directly to foreign shareholders free of taxation for the Dutch Government. It is more likely that the Dutch Government will try to strip out the main bottle necks, firstly the very restrictive interpretation of the permitted activities (no project development - even in the organisation’s own portfolio) and secondly the very complicated ownership/shareholders’ requirements.”

United Kingdom
The UK REIT issue has been debated for many years. However, following the introduction of the SIIC, or French REIT, the progress in the UK has moved on, albeit more slowly than first expected.

Alongside the March 2005 budget statement, HM Treasury and the Inland Revenue published a paper entitled “UK Real Estate Investment Trusts: a discussion paper”. The document confirmed that, “The Government is committed in principle to reforming the taxation of property investment. The consultation has enabled the Government to better define the key features of a potential UK-REIT model that allows for market flexibility. The paper also raised some challenging issues in designing the tax treatment for a model that meets both the needs of the UK property investment market and the Government’s objectives for a UK-REIT. The Government will therefore engage in further dialogue with industry representatives. Subject to finding a workable solution that meets the stated objectives, including reform at no overall cost to the Exchequer, the Government aims to legislate for a UK-REIT in Finance Bill 2006.

There are three key areas where the government wishes to conduct further consultation before the drafting of the legislation can commence:

• How can the Government ensure gearing is not used to manipulate returns and avoid tax? There appears to be a concern that REITs may be exploited by certain sophisticated investors, who may gear up the vehicle and channel interest payments to lenders with tax capacity while allowing capital growth to flow to equity holders.

• How can the Government introduce a REIT regime that works within the UK’s EU commitments and double tax treaty obligations without a loss of UK tax revenue? The issue of the taxation of distributions from the REIT in the hands of non-resident investors is likely to be the greatest hurdle in the delivery of a UK REIT. It is difficult to understand how the UK could achieve its aim of introducing an entirely tax-exempt structure without losing tax revenue from offshore investors – who have the ability to utilise double tax agreements, or EU law.

• How can group structures be accommodated within the proposed regime? The government will need to clarify how any conversion charge will apply on transfers from group companies to a REIT.

Richard White, Tax Partner at Ernst & Young in London and Chairman of the EPRA Tax Transparency Committee (TTC) comments, “whilst there is almost unanimous agreement that a

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5 Three keys points taken from “The Tax Journal” from an article “UK REITs – The Road Ahead” by Peter Beckett and Steve Kirby, Ernst & Young.
tax transparent vehicle for real estate investment is required to enable the UK to compete with other developed economies, the practical difficulties in satisfying the UK Revenue's insistence on tax neutrality are likely to result in, at best, a delay in the introduction of UK REITs or, at worst, the introduction of a model which is not sufficiently attractive to investors to be workable."

Meanwhile, as the REIT discussion continues in the UK, off-shore growth in private vehicles has rocketed. Since 1998 the size of the offshore market has grown from next to nothing, to in excess of $40 billion. HM Treasury is fully aware of this development. However, if we see REIT legislation enacted in 2006, and in a workable and attractive format, we expect to experience a positive impact on the market. UBS estimate that market capitalisation in the UK market could reach $90 billion (currently $50 billion) by 2011.

**Germany**

Germany is the largest country in Europe in GDP terms. However, Germany has one of the smallest listed real estate markets in the region. In fact, there are only three German real estate companies which are constituents of the FTSE EPRA/NAREIT Global Real Estate Index. Germany has a total estimated real estate stock of $8,500 billion, by far the largest real estate stock in Europe, however, only a small fraction is held by institutional real estate investors (approximately $470 billion). Therefore, the opportunity to repackaging, or mobilize, a portion of this real estate is significant.7

In a 196-page document prepared by Germany’s Centre for European Economic Research (ZEW), the European Business School (EBS) and input from Germany’s largest property players, estimates indicate that $140 billion of corporate and $130 billion of unleveraged residential assets could be spun off into REITs. The Initiative Finanzplatz Deutschland (IFD, a key lobby group for the creation of German REITs) expects that $150 billion of real estate can be floated in the next five years (see table.3 below).

<table>
<thead>
<tr>
<th>Table.3 Sources</th>
<th>Property Portfolio ($ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions from:</td>
<td></td>
</tr>
<tr>
<td>Tax Paying companies</td>
<td>70</td>
</tr>
<tr>
<td>Former tax-free residential companies</td>
<td>35</td>
</tr>
<tr>
<td>Conversions:</td>
<td></td>
</tr>
<tr>
<td>Closed-end funds</td>
<td>25</td>
</tr>
<tr>
<td>Open-ended publikum funds</td>
<td>12</td>
</tr>
<tr>
<td>Open-ended special funds</td>
<td>8</td>
</tr>
<tr>
<td>Total</td>
<td>150</td>
</tr>
</tbody>
</table>

Source: IFD, June 2005

The authors of the report state that for REITs to be effective in the German market, they need to be introduced soon to help lift the German real estate market out of crisis. In addition, that a German REIT market would not happen overnight, and estimate that the potential may only be realised over the medium term. However, the report stresses that market volumes and extra income tax for the government cannot be precisely quantified because the success of a REIT strongly depends on the cyclical development of the real estate sector as well as the details of the financial incentives.

On 22 May, the Social Democrats (SPD) lost the state elections in North Rhine-Westphalia. Consequently, Chancellor Gerhard Schroeder announced that he would seek a national election, probably in September 2005. There is a common belief in Germany that there will be a shift in power from Schroeder’s SPD to the Christian Democratic Union (CDU). However, Michael Meiser, vice chairman of the CDU/CSU faction in the German Parliament has stated that he believes the introduction of a German REIT structure would provide a platform to generate employment in the

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6 UBS Investment Research – Q-Series®: German Real Estate, 13 July 2005
7 Introduction of REITs in Germany – A briefing paper, February 2005, issued by Deutsche Bank
financial and real estate sector, without significant costs. Given the developments around Europe, Mr Meiser stressed urgency for the German REIT to be launched quickly and certainly before the UK-REIT.

Max Berkelder, Research Director at Kempen & Co in the Netherlands sums up the position, “The process of the German REIT introduction seems to be on the right track although some tax leakage issues still have to be solved. A German REIT introduction combined with the announced abolition in June 2005 of penalty tax for German investors that hold foreign property stocks will lead to a revolution in the German property sector in the coming five to ten years. The size of the German listed property sector plus the appetite from German investors for REIT stocks will structurally improve”.

UBS estimate that the German REIT will be launched in the second or third quarter of 2006, to be enacted respectively from 1 January 2006. The impact on the European sector could be significant. The IFD estimate that $70 billion of equity from tax paying companies is 60% free float weighted, and then Germany would leap from its current weighting of 3% in the FTSE EPRA/NAREIT Europe Index to approximately 30%. The effect on a global basis would be that Europe increases to approximately 25%, of the global real estate market.

2011 – What will the Pan-European REIT landscape look like?
Graph.3 highlights the weighting shifts in Europe should market growth estimates in Germany and the UK fall in line with current estimates. The German shift is huge, from 3% to 30%. Despite a positive effect on the UK market, its weighting shrinks to 43%. It should be made clear at this point that the French market has grown 50% in the past two and a half years since the introduction of the SIIIC, and we imagine growth to continue. Depending on the outcome of the Dutch FBI revisions, opportunities could arise in this market. It is commonly felt that once Germany and UK have REIT legislation, the other non-REIT countries such as Spain and Sweden will follow suit to remain competitive. In a nutshell, the European market is progressing, albeit slowly, but it is safe to say that the European landscape of the future will offer a far broader set of opportunities to investors.

On a global basis, Europe is set to increase its weighting significantly. From a 20% weighting in 2005, Europe could reach closer to 30% in 2011, as shown in graph.4. Again, similar to the European example, we expect to see continued growth from the Asia/Pacific region – particularly

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8 UBS Investment Research – Q-Series®: German Real Estate, 13 July 2005
9 Estimate does not include UK market growth highlighted earlier in the article.
10 Estimates based on: German - $63 bln & UK $90 bln. All other countries remain at 30 June 2005 levels.
11 Estimates based on: German - $63 bln & UK $90 bln. All other countries remain at 30 June 2005 levels.
Japan, Singapore and Hong Kong. One thing is sure, REIT developments in new countries will force the weighting of the mature REIT markets, such as the United States and Australia, down. Graph.4 indicates that the coverage of the REIT structure could reach 90% of the total global market should the UK and Germany adopt, and experience estimated growth in their REIT markets. Another underlying trend emerging over the past two to three years is the globalisation of the industry both in terms of global real estate portfolios and corporate activity.

Graph.4

![Estimated Global Market Capitalisation Breakdown - 2011](image)

**Source:** FTSE EPRA/NAREIT Global Real Estate Index & UBS Estimates

**Summary**

So will we see an all encompassing pan-European REIT structure? Maybe, but first Europe must see the individual countries with the REIT structure in place. Europe has a long way to go to catch up the established REIT markets in North America and the recent developments in the Asian markets. However, there are a number of positive signs, and if REIT legislation is passed in the UK and Germany in the next 24 months, we can expect to see increased levels of activity and growth in the European market. Given the latent potential of the European market, under the right conditions, estimates envisage an additional $100 billion\(^{12}\) enter the listed market in the next five years. These developments will offer investors a broader universe in a proven asset class. In market capitalisation terms, the size of the European market could easily move in excess of $200 billion, (driven by new issues alone), or approximately 30% of the global market\(^{13}\). Given the expanding Asia/Pacific market, potential growth in Europe, and the increase in investor appetite in this increasingly global asset class, it would not be surprising to see the market capitalisation of the FTSE EPRA/NAREIT Global Real Estate Index step over the $1 trillion mark in the next five years.

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\(^{12}\) Estimate based on the Germany and UK market growth only. Estimate does not include potential growth in other European countries.

\(^{13}\) Estimate based on market size in the Asian/Pacific and North American region remaining at 2005 levels.
Notes:

Author contact details:

Fraser Hughes is Research Director at the European Public Real Estate Association (EPRA) in Amsterdam, The Netherlands. He is a regular contributor to a broad range of publications, and a frequent speaker at real estate conferences. He holds a BA (Hons) in Finance and an MSc in Investment Management from City University, London.

Contact details:
Direct Telephone: +31 20 405 3832
E-mail: f.hughes@epra.com

The European Public Real Estate Association (EPRA) is a not-for-profit association primarily focused on promoting the European quoted real estate sector. Members are real estate companies, investment banks, pension funds, lawyers, accountants and business schools.

Quote contact details:
Max Berkelder, Kempen & Co, Amsterdam, The Netherlands
E-mail: mber@kempen.nl

Richard White, Ernst & Young, London, United Kingdom
E-mail: rwhite2@uk.ey.com

Ronald Wijs, Loyens & Loeff, Amsterdam, The Netherlands
E-mail: Ronald.Wijs@loyensloeff.com